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Income or Loss From Your Business or Profession

As a self-employed person, you report income and expenses from your business or profession separately from your other income, such as income from wages. On Schedule C, you report your business income and itemize your expenses. Any net profit is subject to self-employment tax, as well as regular tax. A net profit can also be the basis of deductible contributions to a SEP or Keogh retirement plan, as discussed in Chapter 41.

If you work out of your home, you may deduct home office expenses.

If you claim a loss on Schedule C, be prepared to show that you regularly and substantially participate in the business. Otherwise, your loss may be considered a passive loss deductible only from passive income, as discussed in Chapter 10.

If you have a business loss that exceeds your other income, you may carry back the loss to three prior years and claim a refund.

If you have no employees and business expenses of $2,500 or less, you may be able to file a simplified schedule called Schedule C-EZ; *see* ¶40.5.

¶40.1 Reporting Self-Employed Income

You file a separate Schedule C along with Form 1040 if you are a sole proprietor of a business or a professional in your own practice. If you are an employee with a sideline business, report the self-employment income from that business on Schedule C. Do not file Schedule C if your business is operated through a partnership or corporation. A guide to Schedule C is in ¶40.5.

Net business profit (or loss) figured on Schedule C is entered on Line 12, Page 1 of Form 1040. Thus, business profit (or loss) is added to (or subtracted from) nonbusiness income on Form 1040. This procedure gives you the chance to deduct your business expenses, whether or not you claim itemized deductions.

On Schedule C, you deduct all of your business expenses from your business income. Then, after adding your business profit to, or subtracting a business loss from, nonbusiness income on Form 1040, you may itemize nonbusiness deductions on Schedule A, such as charitable contributions, taxes, and medical expenses—provided the total of itemized deductions exceeds the standard deduction; *see* ¶13.2.

You may be able to file a simplified schedule, Schedule C-EZ, if your income and expenses are below certain limits; *see* ¶40.5.

Key to Reporting Business and Professional Income and Loss

Item—	*Comments—*
Tax return to file	If you are self-employed, prepare Schedule C to report business or professional income. If your business expenses are $2,500 or less, and you have no employees, you may be able to file a simplified Schedule C-EZ; *see* ¶40.5. If you are a farmer, use Schedule F. You attach Schedule C and/or F to Form 1040. If you operate as a partnership, use Form 1065; if you operate as a corporation, use Form 1120S or Form 1120.
Method of reporting income	The cash or accrual accounting rules determine when you report income and expenses. You must use the accrual basis if you sell a product that must be inventoried. The cash-basis and accrual-basis methods are discussed at ¶40.2.
Tax reporting year	There are two general tax reporting years: calendar years which end on December 31 and fiscal years which end on the last day of any month other than December. Your taxable year must be the same for both your business and nonbusiness income. Most business income must be reported on a calendar-year basis. If, as a self-employed person, you report your business income on a fiscal-year basis, you must also report your nonbusiness income on a fiscal-year basis. Use of a fiscal year is restricted for partnerships and S corporations as explained in Chapter 45.
Office in home	To claim home office expenses as a self-employed person, you must use the home area exclusively and on a regular basis either as a place of business to meet or deal with patients, clients, or customers in the normal course of your business or as your principal place of business. Form 8829 must be used to compute the deduction; *see* ¶40.11.
Social Security coverage	If you have self-employed income, you may have to pay self-employment tax, which goes to financing Social Security benefits; *see* Chapter 46.
Passive participation in a business	If you do not regularly, continuously, and substantially participate in the business, your business income or loss is subject to passive activity restrictions. A loss is deductible only against other passive activity income. The passive activity restrictions are discussed in detail in Chapter 10.
Self-employed Keogh plan	You may set up a retirement plan based on business or professional income. If you are self-employed, you may contribute to a self-employed retirement plan, according to the rules of Chapter 41.
Depreciation	Business assets other than real estate placed in service in 1996 are depreciable over three, five, seven, 10, 15, or 20 years. Automobiles and light trucks, computers, and office equipment are in the five-year class. Property in the three-, five-, seven-, and 10-year classes is depreciable using the double declining balance method, switching to the straight-line method so as to maximize the deduction; *see* Chapter 42 for details. Instead of depreciating equipment, you may claim the first-year expensing deduction. You may generally deduct up to $17,500 in 1996; *see* ¶42.3.
Health insurance	In 1996, you may deduct 30% of premium costs of health insurance coverage for yourself, spouse, and dependents; *see* ¶17.6.
Net operating losses	A loss incurred in your profession or business is deducted from other income reported on Form 1040. If the 1996 loss (plus any casualty loss) exceeds income, the excess may be first carried back to 1993, 1994, and 1995, and then forward 15 years to 1997 through 2011 until it is used up. A loss carried back to a prior year reduces income of that year and entitles you to a refund. A loss applied to a later year reduces income for that year. You may elect to carry forward your loss for 15 years, foregoing the three-year carryback; *see* ¶40.21.
Sideline business	You report business income of a sideline business following the rules that apply to full-time business. For example, if you are self-employed, you report business income on Schedule C or C-EZ. You may also have to pay self-employment tax on this income; *see* Chapter 46. You may also set up a self-employment retirement plan based on such income. If you incur losses over several years, the hobby loss rules of ¶40.9 may limit your loss deduction.

Passive loss restrictions. Pay special attention to the passive loss restrictions discussed in Chapter 10. Generally, if you do not regularly and substantially participate in your business, losses are considered passive and are deductible only against other passive income.

Did You Suffer a Loss?

Business persons and professionals may get a refund of taxes paid in three prior tax years if current business losses exceed present income. If the loss is not fully eliminated by the income of the three prior years, the balance of the loss may be used to reduce your business income for up to 15 of the following years. *See* ¶40.17 for details.

Accounting for Business Income

¶40.2 Accounting Methods for Reporting Business Income

Business income is reported on either the accrual or cash basis. If you have more than one business, you may have a different accounting method for each business.

Inventories. If you have inventories, you *must* use the accrual basis.

Cash basis. You report income items in the taxable year in which they are received; you deduct all expenses in the taxable year in which they are paid. Under the cash basis, income is also reported if it is "constructively" received. You have "constructively" received income when an amount is credited to your account, subject to your control, or set apart for you and may be drawn by you at any time. For example, in 1996 you receive a check in payment of services, but you do not cash it until 1997. You have constructively received the income in 1996, and it is taxable in 1996.

On the cash basis, you deduct expenses in the year of payment. Expenses paid by credit card are deducted in the year they are charged. Expenses paid through a "pay by phone" account with a bank are deducted in the year the bank sends the check. This date is reported by the bank on its monthly statement.

Advance payments. On the cash basis, you may not deduct advance rent payments covering charges of a later tax year. The IRS applies a similar rule to advance payments of insurance premiums; however, an appeals court has allowed an immediate deduction.

Advantage of Cash-Basis Accounting

The cash basis has this advantage over other accounting methods: You may defer reporting income by postponing the receipt of income. For example, if 1996 is a high income year or income tax rates will be lower in 1997, you might extend the date of payment of some of your customers' bills until 1997. But make certain that you avoid the constructive receipt rule. You may also postpone the payment of presently due expenses to a year in which the deduction gives you a greater tax savings.

Cash method of accounting limited. The following may not use the cash method: a regular C corporation, a partnership with a C corporation as a partner, a tax shelter, or a tax-exempt trust with unrelated business income. Exceptions: The cash method may be used by personal service corporations in the fields of medicine, law, engineering, accounting, architecture, performing arts, actuarial science, or consulting. To qualify, substantially all of the stock must be owned directly or indirectly (through partnerships, S corporations, or personal service corporations) by employees. The cash method may also be used by other businesses with average annual gross receipts of $5 million or less, and farming and timber businesses. Tax shelters may not use the cash method; the $5 million gross receipts exception is not available.

Accrual basis. On the accrual basis, report income that has been earned, whether or not received, unless your right to collect the income is unsure because a substantial contingency may prevent payment; *see* the Example below.

EXAMPLE

You report business income as a calendar-year accrual taxpayer. You sell several products on December 27, 1996, and bill the customer in January 1997. You report the sales income on your 1996 Schedule C, even though payment is not made until 1997. Under the accrual method, you are considered to earn the income when the products are sold and delivered to the customer.

Advantage of Accrual-Basis Accounting

The accrual basis has this advantage over the cash basis: It generally gives you a more even and balanced financial report.

Where you are prepaid for future services that must be completed by the end of the next tax year, you report the income in the year that services are performed; *see* the following Example.

EXAMPLE

In 1996, you receive full payment under a one-year contract requiring you to provide 48 music lessons. In 1996, you give eight lessons, and report one-sixth (8/48) of the payment as income. In 1997, the remaining five-sixths of the payment must be reported, even if you do not actually give the required number of lessons.

Expenses under the accrual method are deductible in the year your liability for payment is fixed, even though payment is made in a later year. To prevent manipulation of expense deductions, there are tax law tests for fixing the timing of accrual method expense deductions. The tests generally require that *economic performance* must occur before a deduction may be claimed, but there are exceptions, such as for "recurring expenses." These rules are discussed in IRS Publication 538, which is available without charge from the IRS. However, the basic application of the accrual expense rule can be understood from the following Examples.

EXAMPLES

1. You report business income as a calendar-year accrual taxpayer. In December 1996, you order and receive supplies with an invoice for payment. You pay the bill in 1997. You deduct the expenses on your 1996 Schedule C. Liability was fixed in 1996, and the supplies were delivered in 1996. What if delivery was not until 1997? The expense is deductible in 1996 if the timing of the order and the delivery follows your normal business practice.
2. In 1996, you pay rent for December 1996 and January 1997. You deduct the rent for December on your 1996 return. You defer the deduction of the January rent to your 1997 return.

Expenses owed to a related cash-basis taxpayer. A business expense owed to your spouse, brother, sister, parent, child, grandparent, or grandchild who reports on the cash basis may not be deducted by you until you make the payment and the relative includes it as income. The same rule applies to amounts owed to a controlled corporation (more than 50% ownership) and other related entities.

Long-term contracts. Section 460 of the Internal Revenue Code has a special percentage of completion method of accounting for long-term construction contractors.

Capitalize costs of business property you produce or buy for resale. A complicated statute (Code Section 263A) requires manufacturers and builders to capitalize certain indirect costs (such as administrative costs, interest expenses, storage fees, and insurance), as well as direct production expenses, by including them in inventory costs.

Retailers and wholesalers who acquire real estate for resale also are subject to the uniform capitalization requirements. Purchasers of personal property (not real estate) for resale are exempt from the capitalization rules, unless average annual gross receipts from all businesses for the three prior tax years exceeded $10 million.

Different capitalization methods apply to resellers and manufacturers. Special exceptions apply for farm products. A special production period rule applies to capitalization of interest expenses. Inventory adjustments may be spread over four years. Authors, artists, and photographers are generally exempt from the capitalization requirements; *see* ¶40.8. For further details, *see* IRS Publication 538, Form 3115, and the regulations to Code Section 263A.

Accrual deferral of service income. If, on the basis of your experience, a percentage of billings due for your services will not be collected in that year, you do not have to report that "uncollectible" amount until the year you actually receive it.

However, if interest or a penalty is charged for a failure to make a timely payment, income is reported when the amount is billed. Furthermore, if discounts for early payments are offered, the full amount of the bill must be accrued; the discount for early payment is treated as an adjustment to income in the year payment is made.

The amount of income to be deferred is based on a percentage that considers billing and uncollectibles over the past five most recent years. The percentage is found by dividing the uncollectible amounts by the total billings during the five-year period. That percentage applied to the total billings during the tax year may be deferred. For example, if $200,000 was billed during the five-year period and $20,000 was uncollectible, the percentage is 10% and 10% of the current billings may be deferred. If you do not have a five-year experience, you use the period during which you were in business.

Changing Your Accounting Method

Generally, you must obtain the consent of the Internal Revenue Service prior to any change in accounting method. Apply for consent by filing Form 3115 within 180 days after the beginning of the tax year in which you wish to make the change. Thus, if you report on the calendar-year basis and want to change from the cash method to the accrual method for 1997, file by June 30, 1997.

¶40.3 Tax Reporting Year for Self-Employed

Your taxable year must be the same for both your business and nonbusiness income. If you report your business income on a fiscal-year basis, you must also report your nonbusiness income on a fiscal-year basis.

Generally, you report the tax consequences of transactions that have occurred during a 12-month period. If the period ends on December 31, it is called a calendar year. If it ends on the last day of any month other than December, it is called a fiscal year. A reporting period, technically called a *taxable year*, can never be longer than 12 months unless you report on a 52-to-53-week fiscal-year basis, details of which can be found in IRS Publication 538. A reporting period may be less than 12 months whenever you start or end your business in the middle of your regular taxable year, or change your taxable year.

To change from a calendar year to fiscal-year reporting for self-employment income, you must ask the IRS for permission by filing Form 1128. Support your request with a business reason such as that the use of the fiscal year coincides with your business cycle. To use a fiscal year basis, you must keep your books and records following that fiscal year period.

Fiscal year restrictions. Restrictions on fiscal years for partnerships, personal service corporations, and S corporations are discussed in Chapter 45.

¶40.4 Reporting Business Cash Receipts to the IRS

Cash receipts of more than $10,000 in one business transaction or two or more related transactions must be reported on Form 8300. There are penalties for failure to file.

File Form 8300 with the IRS within 15 days of each cash transaction of over $10,000. Only cash payments are reported; do not report funds received by bank check or wire transfer where cash was not physically transferred. Foreign currency is considered cash. If multiple payments from a single payer (or a payer's agent) are received within a 24-hour period, the payments are aggregated, and the total must be reported if over $10,000.

The reporting requirement applies to individuals, corporations, partnerships, trusts, and estates, except for certain financial institutions that are already required to report cash transactions to the Treasury. Cash received in transactions occurring entirely outside the U.S. does not have to be reported.

The filing requirement applies to cash received for providing goods or services. Thus, an attorney, doctor, or other professional must report cash payments of over $10,000 from a client. Furthermore, cash received for setting up a trust of more than $10,000 for a client must be reported. The IRS has a program to assess penalties against attorneys who have disregarded the cash reporting rules. Courts have held that an attorney may not refuse to report large cash fees by invoking the attorney-client privilege. However, one appeals court held that disclosure of the name of a client who paid cash exceeding $10,000 was not required where disclosure would implicate the client or would reveal confidential communications made by the client to the attorney. The trial court in a closed hearing heard the attorney's claim and ruled against him, but the appeals court ruled in his favor; the circumstances were not disclosed because of their confidential nature.

On an installment sale of business property, you report each payment exceeding $10,000 within 15 days of receipt. If the initial installment is $10,000 or less, you aggregate it plus all payments received within one year of the initial payment. If the total exceeds $10,000, report the total within 15 days after the receipt of the payment that raised the total to over $10,000. In addition, if—after receiving single or aggregated reportable payments—subsequent payments within one year exceed $10,000 individually or in the aggregate, you must report the payments within 15 days.

EXAMPLE

On February 8, 1997, you receive an initial cash payment of $11,000. For the same transaction, you also receive cash of $4,000 on March 15, 1997; $6,000 on April 19, 1997; and $12,000 on June 13, 1997. You report the February payment by February 23, 1997. You also report the payments totaling $22,000 received from March 15, 1997, through June 13, 1997, by June 28, 1997; that is, within 15 days of the date (June 13) that the later payments, all received within a one-year period, exceeded $10,000.

Cash equivalents of $10,000 or less. Cash equivalents such as money orders, traveler's checks, cashier's checks, and bank drafts with a face value of $10,000 or less are treated as cash in sales of consumer durables, collectibles, and travel or entertainment services costing $10,000 or more. Common examples of consumer durables are autos, boats, and jewelry.

For example, if jewelry costing $12,000 is bought with $2,400 cash and traveler's checks of $9,600, the jeweler must file Form 8300 reporting the transaction. If the $2,400 were paid by personal check, the transaction would not have to be reported because personal checks are not treated as cash. Reporting exceptions are also allowed where the cash equivalent constitutes the proceeds of a bank loan, or where it is used as a down payment or promissory note payment under a payment plan used for all retail sales by the seller.

CAUTION

Splitting Up a Transaction

The reporting requirement may not be avoided by splitting up a single transaction into separate transactions. Thus, a sale of property for $36,000 may not be broken down into four separate sales of $9,000 to avoid reporting. Similarly, an attorney who represents a client in a case must aggregate all cash payments by the client, although payments may be spread over several months. If the total exceeds $10,000, it must be reported.

Form 8300. On Form 8300, you must provide the payer's home address and tax identification number to the IRS. You also must provide the payer with a copy of the form or a similar statement by January 31 of the following year.

A $50 penalty may be imposed for each failure to file a properly completed Form 8300 or provide the payer with a statement, unless reasonable cause is shown. The penalty may be reduced if a timely correction is made. For small businesses meeting a $5 million average gross receipts test, the maximum penalty for failure to file with the IRS is $100,000 per calendar year; otherwise, the maximum is $250,000.

If failure to file is intentional, the penalty for each failure is the *greater* of $25,000 and the cash received in the transaction, but the maximum penalty is $100,000. Criminal penalties apply for willful failure to file Form 8300 or for filing a fraudulent form.

There is an exception to the reporting requirement for persons who act as agents if they receive cash of over $10,000 from their principal and use it within 15 days in a cash transaction, provided they identify the principal to the payee in the cash transaction.

You must keep a copy of each Form 8300 you file with the IRS for five years from the date of filing.

Reporting Income and Expenses on Schedule C

¶40.5 How To File Schedule C

In this section are explanations of how a sole proprietor reports income and expenses on Schedule C, a sample of which is on page 526.

Schedule C-EZ. This simple form is designed for persons on the cash basis who do not have a net business loss and have:

- Business expenses of $2,500 or less;
- No inventory at any time during the year;
- Only one sole proprietorship;
- No employees;
- No home office expense deduction;
- No prior-year suspended passive activity losses from this business; and
- No depreciation to be reported on Form 4562.

Statutory employees: Full-time life insurance salespersons, commission drivers, and full-time outside salespersons. Statutory employees report income and expenses on Schedule C. Thus, expenses may be deducted in full on Schedule C rather than as a miscellaneous itemized deduction (¶19.1), subject to the 2% adjusted gross income (AGI) floor on Schedule A.

Statutory employees are full-time life insurance salespersons, agents or commission drivers, pieceworkers, and full-time traveling or city salespersons who solicit on behalf of and transmit to their principals orders from wholesalers and retailers for merchandise for resale or for supplies.

The term *full time* refers to an exclusive or principal business activity for a single company or person and not to the time spent on the job. If your principal activity is soliciting orders for one company, but you also solicit incidental orders for another company, you are a full-time salesperson for the primary company. Solicitations of orders are considered incidental to a principal business activity if you devote 20% or less of your time to the solicitation activity. A city or traveling salesperson is presumed to meet the principal business activity test in a calendar year in which he or she devotes 80% or more of working time to soliciting orders for one principal.

IRS regulations give this example: A salesman's principal activity is getting orders from retail pharmacies for a wholesale drug company called Que Company. He occasionally takes orders for two other companies. He is a statutory employee only for Que Company.

If you are a statutory employee, your company checks Box 15 on Form W-2, identifying you as a statutory employee. Although a statutory employee may treat job expenses as business expenses, the employer withholds FICA (Social Security and Medicare) taxes on wages and commissions. However, a statutory employee has the option of allowing his or her employer to withhold federal income taxes or to meet the employee's tax liability through the payment of estimated tax.

You must check a box on Line 1 of Schedule C (or C-EZ) to indicate statutory employee status. If you also have self-employment earnings from another business, you must report the self-employment earnings and statutory employee income on separate Schedules C. If both types of income are earned in the same business, allocate the expenses between the two activities on the separate schedules.

Gross receipts or sales on Schedule C (Line 1): If you do not produce or sell goods, but provide only services, you do not determine cost of goods sold, but report only your receipts from services on Line 1. (A sample of Schedule C in the Supplement illustrates the case of a retail business selling merchandise that is required to determine the cost of goods sold using Part III of Schedule C.)

Do not report as receipts on Schedule C the following items:

- Gains or losses on the sale of property used in your business or profession. These transactions are reported on Schedule D and Form 4797.
- Dividends from stock held in the ordinary course of your business. These are reported as dividends from stocks that are held for investment.

Deductions on Schedule C: Deductible business expenses are claimed in Part II; the descriptive breakdown of items is generally self-explanatory. However, note these points:

Bad debts (Line 9): Business bad debt rules are discussed at ¶5.9. Cash-basis taxpayers may not claim a business bad debt for payments that have not been received or which are uncollectible, where the payments have not been reported as income.

Car and truck expenses (Line 10): In the year you place a car in service, you may choose between the IRS mileage allowance and deducting actual expenses, plus depreciation. You must also attach Form 4562 to support the deduction; *see* Chapter 43.

Depreciation (Line 13): Enter here the amount of your annual depreciation deduction. A complete discussion of depreciation may be found in Chapter 42. You must figure your depreciation deduction on Form 4562 for assets placed in service in 1996, or for cars, computers, or other "listed property," regardless of when the assets were placed in service.

Employee benefit programs (Line 14): Enter your cost for the following programs you provide for your employees: accident or health plans; wage continuation; self-insured medical reimbursement plans; educational assistance programs; supplemental unemployment benefits; and prepaid legal expenses. Retirement plans, such as pension and profit-sharing plans, are reported separately on Line 19.

Insurance other than health insurance (Line 15): Insurance policy premiums for the protection of your business, such as accident, burglary, embezzlement, marine risks, plate glass, public liability, workers' compensation, fire, storm, or theft, and indemnity bonds upon employees, are deductible. State unemployment insurance payments are deducted here or as taxes if they are considered taxes under state law.

Premiums paid on an insurance policy on the life of an employee or one financially interested in a business, for the purpose of protecting you from loss in the event of the death of the insured, are not deductible.

Prepaid insurance premiums are deducted ratably over the term covered by the policy, whether you are on a cash or accrual basis. However, an appeals court allowed a cash-basis taxpayer to take an immediate deduction for premiums paid on a policy covering more than a year.

Premiums for disability insurance to cover loss of earnings when out ill or injured are nondeductible personal expenses. But you may deduct premiums covering business overhead expenses.

Note*: You do not claim on Schedule C the deduction of 30% of health insurance costs for yourself, your spouse, and your dependents. You take the deduction on Line 26, Form 1040.*

CAUTION

Doctor's Malpractice Insurance

A self-employed doctor may deduct the premium costs of malpractice insurance. However, a doctor who is not self-employed but employed by someone else, say a hospital, may deduct the premium costs only as an itemized deduction. Whether malpractice premiums paid to a physician-owned carrier are deductible depends on how the carrier is organized. If there is a sufficient number of policyholders who are not economically related and none of whom owns a controlling interest in the insuring company, a deduction is allowed provided the premiums are reasonable and are based on sound actuarial principles.

In one case, physicians set up a physician-owned carrier which was required by state insurance authorities to set up a surplus fund. The physicians contributed to the fund and received nontransferable certificates that were redeemable only if they retired, moved out of the state, or died. The IRS and Tax Court held the contributions to the fund were nondeductible capital expenses.

In another case, a professional corporation of anesthesiologists set up a trust to pay malpractice claims, up to specified limits. The IRS and Tax Court disallowed deductions for the trust contributions on the grounds that the PC remained potentially liable. Malpractice claims within the policy limits might exceed trust funds and the PC would be liable for the difference. Since risk of loss was not shifted to the trust, the trust was not a true insurance arrangement.

Interest (Line 16): Include interest on business debts, but prepaid interest that applies to future years is not deductible.

Deductible interest on an insurance loan is limited if you borrow against a life insurance policy covering yourself as an employee or the life of any other employee, officer, or other person financially interested in your business. Interest on such a loan is deductible only if the loan is no more than $50,000 per employee or other covered person. If you own policies covering the same employees (or other persons) in more than one business, the $50,000 limit applies on an aggregate basis to all the policies. The interest deduction limit applies even if a sole proprietor borrows against a policy on his or her own life and uses the proceeds in a business; interest is not deductible to the extent the loan exceeds $50,000. The loan limit applies to all policies purchased after June 20, 1986, in taxable years ending after that date.

Pension and profit-sharing plans (Line 19): Keogh plan or SEP contributions made for your employees are entered here; contributions made for your account are entered directly on Form 1040 as an adjustment to income. In addition, you may have to file an information return by the last day of the seventh month following the end of the plan year; *see* ¶41.8.

Rent on business property (Line 20): Rent paid for the use of lofts, buildings, trucks, and other equipment is deductible. However, you may not deduct the entire amount of an advance rental in the year of its payment. This is true even if you are on the cash basis. You deduct only that portion of the payment attributed to the use of the property in the taxable year. For example, you sign a 10-year lease calling for yearly rental payments of $2,000. You pay the first year's rent on July 1. In your tax return for the calendar year, you may deduct only $1,000 (6⁄12 of $2,000). However, an appeals court allowed a calendar-year cash-basis lessee to deduct advance rentals where the rental payments covered a period of a year or less. For example, on December 1, 1996, the lessee pays the entire rental due for the lease ending November 30, 1997. While the IRS would allow only 1⁄12 of the payment to be deductible in 1996, the appeals court would allow a deduction for the entire payment. The court believes this approach is within the spirit of the cash-basis rule. In the case of a long-term lease where advance rental payments cover no more than a year beyond the year of payment, the IRS proration rule sacrifices the simplicity of the cash-basis method without a meaningful change in the timing of deductions, according to the appeals court.

Taxes on leased property that you pay to the lessor are deductible as additional rent.

Repairs (Line 21): The cost of repairs and maintenance is deductible provided they do not materially add to the value of the property or appreciably prolong its life. Expenses of replacements that arrest deterioration and appreciably increase the value of the property are capitalized and their cost recovered through depreciation.

Taxes (Line 23): Deduct real estate and personal property taxes on business assets here. Also deduct your share of Social Security and Medicare taxes paid on behalf of employees and payments of federal unemployment tax. Federal highway use tax is deductible. Federal import duties and excise and stamp taxes normally not deductible as itemized deductions are deductible as business taxes if incurred by the business. Taxes on business property, such as an *ad*

Schedule C—Worksheet goes here.

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valorem tax, must be deducted here; they are not to be treated as itemized deductions. However, the IRS holds that you may not deduct state income taxes on business income as a business expense. Its reasoning: Income taxes are personal taxes even when paid on business income. As such, you may deduct state income tax only as an itemized deduction on Schedule A. The Tax Court supports the IRS rule on the grounds that it reflects Congressional intent toward the treatment of state income taxes in figuring taxable income. However, the Tax Court's position is inconsistent, by allowing business expense deductions from gross income for interest paid on state and federal income tax deficiencies and legal fees incurred on tax audits of business income.

Interest on a tax deficiency was held deductible by a majority of the Tax Court in a dispute involving a change of accounting method. The Tax Court majority rejected an IRS regulation that holds that interest on a tax deficiency is always nondeductible personal interest. However, the majority warned that not all business tax deficiencies would support a deduction of interest. For example, in the case of disallowed expenses, the dispute must involve the issue of whether they were ordinary and necessary business expenses. A deficiency arising from a tax avoidance transaction would not support a deduction of interest. Dissenting Tax Court judges argued that interest on a tax deficiency is a nondeductible personal expense and never a business expense because the obligation to pay income taxes is based on the concept of personal income.

A federal appeals court (Eighth Circuit) has upheld the IRS position denying a business expense deduction for interest on a tax deficiency.

For purposes of computing a net operating loss, state income tax on business income is treated as a business deduction.

If you pay or accrue sales tax on the purchase of nondepreciable business property, the sales tax is a deductible business expense. If the property is depreciable, add the sales tax to the cost basis for purposes of computing depreciation deductions.

Travel, meals, and entertainment (Line 24): Travel expenses on overnight business trips while "away from home" (¶20.6) and 50% of meals and entertainment for business are deductible. Total meals and entertainment expenses are listed on Line 24b and then reduced by 50% on Line 24c. The total amount after figuring the 50% reduction is reported on Line 24d.

Self-employed persons may use the IRS meal allowance rates discussed at ¶20.4, instead of claiming actual expenses. *See also* ¶20.28 for record-keeping requirements for travel and entertainment expenses.

Utilities (Line 25): Deduct utilities such as gas, electric, and telephone expenses incurred in your business. However, if you have a home office (¶40.11), you may *not* deduct the base rate (including taxes) of the *first* phone line into your home; *see* ¶19.14.

Wages (Line 26): You do not deduct wages paid to yourself. You may deduct reasonable wages paid to family members who work for you. If you have an employee who works in your office and also in your home, such as a domestic, you deduct that part of the salary allocated to the work in your office. If you take a targeted jobs credit, the wage deduction is reduced by the credit.

Other expenses (Line 27). In Part V of Schedule C, you list deductible expenses not reported in Part II, such as amortizable business start-up costs.

¶40.6 Deductions for Professionals

The following expenses incurred by self-employed professionals in the course of their work are generally allowed as deductions from income when figuring profit (or loss) from their professional practices on Schedule C:

- Dues to professional societies.
- Operating expenses and repairs of car used on professional calls.
- Supplies.
- Subscriptions to professional journals.
- Rent for office space.
- Cost of fuel, light, water, and telephone used in the office.
- Salaries of assistants.
- Malpractice insurance; *see* ¶40.5.
- Cost of books, information services, professional instruments, and equipment with a useful life of one year or less. Professional libraries are depreciable if their value decreases with time. Depreciation rules are discussed at ¶42.1.
- Fees paid to a tax preparer for preparing Schedule C and related business forms.

Professionals as employees. Professionals who are not in their own practice may *not* deduct professional expenses on Schedule C. Salaried professionals may deduct professional expenses only as miscellaneous itemized deductions on Schedule A, subject to the 2% adjusted gross income (AGI) floor; *see* ¶19.1. However, "statutory" employees may use Schedule C; *see* ¶40.5.

The cost of preparing for a profession. You may not deduct the cost of a professional education and the cost of establishing a professional reputation; *see* ¶19.16.

The IRS does not allow a deduction for the cost of a license to practice. However, the Tax Court has allowed attorneys to amortize over their life expectancy bar admission fees paid to state authorities; *see* ¶19.17.

The costs of courses taken to keep abreast of professional developments are usually deductible; *see* ¶19.15.

Payment of clients' expenses. An attorney may follow a practice of paying his or her clients' expenses in pending cases. The IRS will disallow a deduction claimed for these payments on the grounds that the expenses are those of the client, not the attorney. The courts agree with the IRS position where there is a net fee agreement. In a net fee agreement, expenses first reduce the recovery before the attorney takes a fee. However, where the attorney is paid under a gross fee agreement, an appeals court has reversed a Tax Court decision that disallowed the deduction of the attorney's payment of client expenses. Under a gross fee agreement, the attorney's fee is based on the gross award; the prior payment of expenses does not enter into the fee agreement and so is not reimbursed. Because he

would not be reimbursed, an attorney claimed his payment of client expenses was deductible. An appeals court accepted this argument and allowed the deduction. The court allowed the deduction although California law disapproved of the practice of paying client expenses without a right of reimbursement. The court believed that there is no ethical difficulty with the practice and other jurisdictions approve of it. It is necessary for and it is the practice of personal injury firms to pay the costs of many of their clients.

If you are not allowed a current deduction for payment of clients' expenses, you may deduct your advance as a bad debt if the claim is worthless in another year; *see* ¶5.10.

An attorney might deduct a payment to a client reimbursing the client for a bad investment recommended by the attorney. A court upheld the deduction on the grounds that the reimbursement was required to protect the reputation of an established law practice. However, no deduction is allowed when malpractice insurance reimbursement is available but the attorney fails to make a claim.

Daily business lunches with associates have been held to lack business purpose. Courts agree with the IRS that professionals do not need to have lunch together every day to talk shop. The cost of the meals is therefore not deductible.

EXAMPLES

1. A law partnership deducted the meal costs of the staff attorneys who lunched every day at the same restaurant to discuss cases and court assignments. The deductions were disallowed as personal expenses. The Tax Court and an appeals court agreed with the IRS that daily lunches are not necessary. Co-workers generally do not need luncheons to provide social lubrication for business talk, as is true with clients.

2. A physician held luncheon meetings three or four times a week with other physicians. He argued that the purpose of the luncheons was to generate referrals. A court held that such frequent luncheons became a routine personal event not tied to specific business. The cost of the meals was not deductible.

3. A medical professional corporation (PC) deducted the cost of meals taken by its physician-stockholders at a hospital cafeteria. It argued that the doctors discussed patients and met other doctors who made referrals to them. The Tax Court agreed with the IRS that the meal costs were not deductible; doctors ate in the cafeteria for their personal convenience. Furthermore, the payments were taxed to the doctors as dividends. The court noted that the PC might have been able to claim a deduction had it treated the meal payments as taxable pay; however, the PC refused to take this position, unsuccessfully gambling that it could claim the costs as business deductions.

¶40.7 Nondeductible Expense Items

Capital expenditures may not be deducted. Generally, the cost of acquiring an asset or of prolonging its life is a capital expenditure that must be amortized over its expected life.

EXAMPLE

A new roof is installed on your office building. If the roof increases the life of the building, its cost is a capital expenditure recovered by depreciation deductions. The cost of repairing a leak in the roof is a deductible operating expense. A deduction was allowed for the cost of a major roof renovation on evidence that the work was not designed to increase the value of the building but to correct the defect.

If the useful life of an item is less than a year, its cost, including sales tax on the purchase, is deductible. Otherwise, you may recover your cost only through depreciation except to the extent first-year expensing applies; *see* ¶42.3.

Expenses while you are not in business. You are not allowed to deduct business expenses incurred during the time you are not engaged in your business or profession.

EXAMPLE

A lawyer continued to maintain his office while he was employed by the government. During that time he did no private law work. He only kept the office to have it ready at such time as he quit the government job and returned to practice. His costs of keeping up his office while he was working for the government were not deductible.

Payments of fines. You may not deduct the payment of a fine, even though your violation was unintentional.

Bribes and kickbacks. Bribes and kickbacks are not deductible if they are illegal under a federal or a generally enforced state law which subjects the payer to a criminal penalty or provides for the loss of license or privilege to engage in business. A kickback, even if not illegal, is not deductible by a physician or other person who has furnished items or services that are payable under the Social Security Act (including state programs). A kickback includes payments for referral of a client, patient, or customer.

In one case, the IRS, with support from the Tax Court and a federal appeals court, disallowed a deduction for legal kickbacks paid by a subcontractor. The courts held that the kickbacks were not a "necessary" business expense because the contractor had obtained nearly all of its other contracts without paying kickbacks, including contracts from the same general contractor bribed here.

¶40.8 How Authors and Artists May Write Off Expenses

Self-employed authors, artists, photographers, and other qualifying creative professionals may write off business expenses as they are paid. The law (Code Section 263A) that requires expenses to be amortized over the period income is received does not apply to freelancers who personally create literary manuscripts, musical or dance scores, paintings, pictures, sculptures, drawings, cartoons, graphic designs, original print editions, photographs, or photographic negatives or transparencies. Furthermore, expenses of a personal service corporation do not have to be amortized if they directly relate to expenses of a qualifying author, artist, or photographer who owns (or whose relatives own) substantially all of the corporation's stock.

Current deductions are *not* allowed for expenses relating to motion picture films, videotapes, printing, photographic plates, or similar items.

An author or artist with expenses exceeding income may be barred by the IRS from claiming a loss; in that case, the profit-presumption rule of ¶40.9 may allow a deduction of the loss.

¶40.9 Deducting Expenses of a Sideline Business or Hobby

There is a one-way tax rule for hobbies: Income from a hobby is taxable; expenses are deductible only to the extent you have income, and the deduction is limited on Schedule A by the 2% adjusted gross income (AGI) floor for miscellaneous itemized deductions. Hobby losses are considered nondeductible personal losses. A profitable sale of a hobby collection or activity held long term is taxable as capital gain; losses are not deductible.

LAW ALERT

Hobby or Sideline Business

The question of whether an activity, such as dog breeding or collecting and selling coins and stamps, is a hobby or sideline business arises when losses are incurred. As long as you show a profit, you may deduct the expenses of the activity. But when expenses exceed income and your return is examined, an agent may allow expenses only up to the amount of your income and disallow the remaining expenses that make up your loss. At this point, to claim the loss, you may be able to take advantage of a "profit presumption" discussed in this section, or you may have to prove that you are engaged in the activity to make a profit.

How to deduct hobby expenses. If the profit presumption discussed later does *not* apply and the activity is held *not* to be engaged in for profit, expenses are deductible only as itemized deductions and only up to the extent of income from the activity; a deduction for expenses exceeding the income is disallowed.

A special sequence is followed in determining which expenses are deductible from income. Deducted first on Schedule A are amounts allowable without regard to whether the activity is a business engaged in for profit, such as interest and state and local taxes, as well as casualty losses. If any income remains, first deduct "business" operating expenses such as wages, utilities, advertising, repairs, and maintenance. Then deduct depreciation to the extent of remaining income. The "business" expenses and depreciation are allowed only as miscellaneous itemized deductions subject to the 2% AGI floor; *see* ¶19.1. Thus, even if the expenses offset income from the activity, the expenses will not be deductible unless your total miscellaneous expenses (including those from the activity) exceed 2% of your adjusted gross income.

Presumption of profit-seeking motive. You are *presumed* to be engaged in an activity for profit if you can show a profit in at least three of the last five years, including the current year. If the activity is horse breeding, training, racing, or showing, the profit presumption applies if you show profits in two of seven consecutive years. The presumption does not necessarily mean that losses will automatically be allowed; the IRS may try to rebut the presumption. You would then have to prove a profit motive by showing these types of facts: You spend considerable time in the activity; you keep businesslike records; you relied on expert advice; you expect the assets to appreciate in value; and losses are common in the start-up phase of your type of business.

Election postpones determination of profit presumption. If you have losses in the first few years of an activity and the IRS tries to disallow them as hobby losses, you have this option: You may make an election on Form 5213 to postpone the determination of whether the above profit presumption applies. The postponement is until after the end of the fourth taxable year following the first year of the activity. For example, if you enter a farming activity in 1993, you can elect to postpone the profit motive determination until after 1997. Then, if you have realized profits in at least three of the five years (1993 to 1997), the profit presumption applies. When you make the election on Form 5213, you agree to waive the statute of limitations for all activity-related items in the taxable years involved. The waiver generally gives the IRS an additional two years after the filing due date for the last year in the presumption period to issue deficiencies related to the activity.

To make the election, you must file Form 5213 within three years of the due date of the return for the year you started the activity. Thus, if you started your activity during 1996, you have until April 15, 2000, to make the election. If before the end of this three-year period you receive a deficiency notice from the IRS disallowing a loss from the activity and you have not yet made the election, you can still do so within 60 days of receiving the notice.

These election rules apply to individuals, partnerships, and S corporations. An election by a partnership or S corporation is binding on all partners or S corporation shareholders holding interests during the presumption period.

¶40.10 Deducting Expenses of Looking for a New Business

When you are planning to invest in a business, you may incur preliminary expenses for traveling to look at the property and for legal or accounting advice. Expenses incurred during a general search or preliminary investigation of a business are not deductible, including expenses related to the decision whether or not to enter a transaction. However, when you go beyond a general search and focus on acquiring a particular business, you may deduct the start-up expenses. The timing of the deduction depends on whether or not you actually go into the business.

Amortizable expenses if you go into business. When you go into a business, you may elect to amortize over at least a 60-month period the costs of investigating and setting up the business, such as expenses of surveying potential markets, products, labor supply, and transportation facilities; travel and other expenses incurred in lining up prospective distributors, suppliers, or customers; salaries or fees paid to consultants or attorneys, and fees for similar professional services. The business may be one you acquire from someone else or a new business you create. The amortization period starts when you actually begin or acquire a going business.

How To Claim Amortization

The election to amortize start-up expenses is made by claiming the deduction on Form 4562, and by attaching a statement to the return for the first year you are in business. In the statement, describe the expenses, when they were incurred, the date the business began, and the number of months (not less than 60) in the amortization period.

Organizational costs for a partnership or corporation. Costs incident to the creation of a partnership or corporation are also amortizable over a period of at least 60 months. For a partnership, qualifying expenses include legal fees for negotiating and preparing a partnership agreement, and management, consulting or accounting fees in setting up the partnership. Amortization is not allowed for syndication costs of issuing and marketing partnership interests such as brokerage and registration fees, fees of an underwriter, and costs of preparing a prospectus.

For a corporation, amortizable expenses include the cost of organizational meetings, incorporation fees, and accounting and legal fees for drafting corporate documents. Costs of selling stock or securities, such as commissions, do not qualify.

The election to amortize is made on Form 4562 for the first year the partnership or corporation is in business. A statement attached to the return must describe the expenses and the amortization period.

Nonamortizable expenses. Amortizable expenses are restricted to expenses incurred in investigating the acquisition or creation of an active business, and setting up such an active business. They do not include taxes, interest, research, or experimental costs deductible under Code Section 174. Expenses of looking for investment property may not be amortized. For rental activities to qualify as an active business, there must be significant furnishing of services incident to the rentals. For example, the operation of an apartment complex, an office building, or a shopping center would generally be considered an active business.

You may *not* amortize the expenses incurred in acquiring or selling securities or partnership interests such as securities registration expenses or underwriters' commissions. You may *not* amortize the costs of acquiring property to be held for sale or property which may be depreciated or amortized, including expenses incident to a lease and leasehold improvements.

You may not claim any deduction for start-up expenses if you do not elect to amortize. For example, if you incur expenses prior to completion of a building to be used in an active rental business, such as rental payments for leasing the land on which the building is to be constructed, you must elect to amortize the expenses or you will lose the deduction. If you do not elect to amortize, you treat the expenses as follows:

- Costs connected with the acquisition of capital assets are capitalized and depreciated; and
- Costs related to assets with unlimited or indeterminable useful lives are recovered only on the future sale or liquidation of the business.

If the acquisition fails. Where you have gone beyond a general search and have focused on the acquisition of a particular business, but the acquisition falls through, you may deduct the expenses as a capital loss.

EXAMPLES

1. In search of a business, you place newspaper advertisements and travel to investigate various prospective ventures. You pay for audits to evaluate the potential of some of the ventures. You then decide to purchase a specific business and hire a law firm to draft necessary documents. However, you change your mind and later abandon your plan to acquire the business. According to the IRS, you may not deduct the related expenses for advertisements, travel, and audits. These are considered investigatory. You may deduct the expense of hiring the law firm.
2. Domenie left his job to invest in a business. He advertised and was contacted by a party who wished to sell. He agreed to buy, hired an attorney, transferred funds to finance the business, and worked a month with the company manager to familiarize himself with the business. Discovering misrepresentations, he refused to buy the company and deducted over $5,000 for expenses, including travel and legal fees. The IRS disallowed the deduction as incurred in a business search. The Tax Court disagreed. Domenie thought he had found a business and acted as such in transferring funds and drawing legal papers for a takeover.

Job-hunting costs. For deducting the expenses of looking for a new job, *see* ¶19.7.

Business Use of a Home

¶40.11 Exclusive and Regular Use of a Home Office

If you operate your business from your home, using a room or other space as an office or area to assemble or prepare items for sale, there are several obstacles to deducting the expenses allocated to the business area. The fact that there is a business purpose for your use of an office at your home is not a sufficient basis for deducting expenses of a home office. To deduct home office expenses, you must prove that you use the home area *exclusively* and on a *regular basis* either as:

1. A place of business to meet or deal with patients, clients, or customers in the normal course of your business, *or*

2. Your principal place of business. Your home office will qualify as your principal place of business if you spend most of your working time there and most of your business income is attributable to your activities there.

Two steps are followed to determine whether a home office is the principal place of business: (1) A review of the activity at each business location and the relative importance of each. The place where a person is required to meet with clients or patients, deliver goods, or perform services is generally the principal place of business, especially if that place has unique or special characteristics, as a hospital does. (2) A review of the time spent at each location if it is difficult to make a determination under Step 1. Under these tests, an anesthesiologist's home office expenses are not deductible because the principal place of his business as an anesthesiologist is at the hospitals where he works. That he needs the home office to do administrative work because he had no office space at the hospitals does not make the home office his principal place of business.

Similarly, a self-employed plumber may not deduct home office expenses where he spends 40 hours a week at customers' homes and 10 hours a week in a home office talking with customers over the phone, ordering supplies, and scheduling appointments, assisted by a full-time employee who works in the home office. According to the IRS, the activities at the home office may be important, but not as important as the service calls to customers. Therefore, the home office is not the plumber's principal place of business. On the other hand, a deduction was allowed to a self-employed retailer of costume jewelry who spends 25 hours a week at a home office filling and shipping orders, ordering supplies, and keeping the business books, while spending 15 hours a week at craft shows and consignment sale locations. Here, the IRS says that since sales to customers, the most important part of the business, occur inside and outside the home, the "relative importance" test is inconclusive. However, since more time is spent at the home office than on the road, the home office qualifies as the principal place of business.

Exclusive and regular business use of home area required. If you use a room, such as a den, both for business and family purposes, be prepared to show that a specific section of the den is used *exclusively* as office space. A partition or other physical separation of the office area is helpful but not required.

Under the regular basis test, expenses attributable to incidental or occasional trade or business use are not deductible, even if the room is used for no other purpose but business. For example, a real estate operator was not allowed to deduct the cost of a home office, on evidence that he also used the office area for nonbusiness purposes.

Even if you meet these tests, your deduction for allocable office expenses may be substantially limited or barred by a restrictive rule that limits deductions to the income from the office activity. This computation is made on Form 8829 and is illustrated in ¶40.14.

CAUTION Principal Place of Business Test

The tests for deducting office expenses will generally not present problems where the home area is the principal place of business or professional activity. For example, you are a doctor and see most of your patients at an office set aside in your home. A tax dispute may arise where you have a principal place of business elsewhere and use a part of your home for occasional work or administrative paperwork. Occasional use is not sufficient. If your deduction is questioned, you must prove that the area is used regularly and exclusively to meet with customers, clients, or patients. Have evidence that you have actual office facilities. Furnish the room as an office—with a desk, files, and a phone used only for business calls. Also keep a record of work done and business visitors.

You may not deduct the cost of a home office if you use the office only to do administrative paperwork.

Multiple business use of home office. If you use a home office for more than one business, make sure that the home office tests are met for all businesses before you claim deductions. If one business use qualifies and another use does not, the IRS will disallow deductions even for the qualifying use.

Employee with sideline business. Employees who use a home office for their job and for a sideline business also should be aware of this problem. Most employees are unable to show that their home

office is the principal place of their work. Claiming an unallowable deduction for employee home office use will jeopardize the deduction for sideline business use. This happened to Hamacher, who as a self-employed actor earned $24,600 over a two-year period from an Atlanta theater and a few radio and television commercials. He also earned $18,000 each year as the administrator of an acting school at the theater. For his job as administrator, Hamacher shared an office at the theater with other employees. He had access to this office during nonbusiness hours. He also used one of the six rooms in his apartment for an office. Because of interruptions at the theater, he used the home office to work on the school curriculum and select plays for the theater. In connection with his acting business, he used the home office to receive phone calls, to prepare for auditions, and rehearse for acting roles.

The IRS disallowed his deduction for both self-employment and employee purposes because Hamacher's office use as an employee did not qualify. The Tax Court agreed. A single-office space may be used for different business activities, but all of the uses must qualify for a deduction. Here, Hamacher's use of the home office as an employee did not qualify. He had suitable office space at the theater. He was not expected or required to do work at home. As the employee use of the home office did not qualify, the Tax Court did not have to determine if the sideline business use qualified. Even if it had qualified, no allocation of expenses between the two uses would have been made. By requiring that a home office be used "exclusively" as a principal place of business or place for seeing clients, patients, or customers, the law imposes an all-or-nothing test.

Separate structure. If in your business you use a separate structure not attached to your home, such as a studio adjacent but unattached to your home, the expenses are generally deductible if you satisfy the exclusive use and regular basis tests discussed earlier. A separate structure does not have to qualify as your principal place of business or a place for meeting patients, clients, or customers. However, the income limitation discussed at ¶40.14 applies. In one case, a taxpayer argued that an office located in a separate building in his backyard was not subject to the exclusive and regular business use tests and the gross income limitation. However, the IRS and Tax Court held that it was. The office building was "appurtenant" to the home and thus part of it, based on these facts: The office building was 12 feet away from the house and within the same fenced-in residential area; it did not have a separate address; it was included in the same title and subject to the same mortgage as the house, and all taxes, utilities, and insurance were paid as a unit for both buildings.

Day-care services. The exclusive-use test does not have to be met for business use of a home to provide day-care services for children and handicapped persons, or persons age 65 or older, provided certain state licensing requirements are met. If part of your home is *regularly* but not exclusively used to provide day-care services, you may deduct an allocable part of your expenses. You allocate expenses by multiplying the total costs by two fractions: (1) The total square footage in the home that is available for day-care use throughout each business day and regularly so used, divided by the total square footage for the home. (2) The total hours of operation divided by the total number of hours in a year (8,760).

If the area *is* exclusively used for day-care services, only fraction (1) applies.

EXAMPLE

Alice Jones operates a day-care center at home from 7 a.m. to 6 p.m., five days a week, 250 days a year. Her family uses the area the rest of the time. Annual home expenses total $10,000 ($5,000 for interest and taxes; $4,000 for electricity, gas, water, trash collection, maintenance, and insurance; and $1,000 for depreciation). The total floor area of the home is 2,000 square feet; 1,500 square feet are used for day-care purposes. Alice multiplies her $10,000 of expenses by 75%, the part of the home used for day-care purposes (1,500 square feet ÷ 2,000 square feet), and also by 31.39%, the percentage of business-use time (2,750 hours ÷ 8,760 hours). Thus, she may deduct $2,354: $10,000 × 75% × 31.39%. The full $2,354 is deductible only if net income generated from the day-care facility is at least that much.

In one case, the Tax Court held that utility rooms, such as a laundry and storage room and garage, may be counted as part of the day-care business area. The IRS had argued that because the children were not allowed in these areas, the space could not be considered as used for business. The Tax Court disagreed. The laundry room was used to wash the children's clothes; the storage room and garage were used to store play items and equipment. Thus, the space was considered as used for child care even though the rooms were off limits to the children.

Form 8829

You must report deductible home office expenses on Form 8829. Part I is used for showing the space allocated to business use (¶40.13); Part II for reporting deductible expenses allocated to business use (¶40.14); Part III for figuring depreciation on the business area (¶40.12); and Part IV for carryover of expenses not allowed in 1995 because of income limitations applied in Part II (¶40.14). A sample copy of Form 8829 is on the next page.

Storage space and inventory. If your home is the only location of a business selling products, you may deduct expenses allocated to space regularly used for inventory storage, including product samples, if the space is separately identifiable and suitable for storage.

¶40.12 What Home Office Expenses Are Deductible

Depending on your income (¶40.14), a deduction for home business use may include real estate taxes, mortgage interest, operating expenses (such as home insurance premiums and utility costs), and depreciation allocated to the area used for business.

The deduction is figured on Form 8829 and entered on Line 30 of Schedule C.

Form 8829—Worksheet goes here.

Leave at least 1 pica of white space above form and 1 pica of white space below form.

Household expenses and repairs that do not benefit that space are not deductible. However, a pro rata share of the cost of painting the outside of a house or repairing a roof may be deductible. Costs of lawn care and landscaping are not deductible. No portion of the basic rental charge for the first telephone line in your home is deductible; *see* ¶19.14.

If you install a security system for all your home's windows and doors, the portion of your monthly maintenance fee that is allocable to the office area is a deductible operating expense. Furthermore, the business portion of your cost for the system is depreciable. Thus, if the office takes up 20% of your home (¶40.13) you may deduct, subject to the income limitation of ¶40.14, 20% of the maintenance fee and a 20% depreciation deduction.

Figuring depreciation. For depreciation purposes, the cost basis of the house is the lower of the fair market value of the house at the time you started to use a part of it for business, and its adjusted basis, exclusive of the land. Only that part of the cost basis allocated to the office is depreciable. Form 8829 has a special section, Part III, for making this computation.

EXAMPLE

In April 1996, you start to use one room in your house exclusively and on a regular basis to meet with clients. This room is 10% of the square footage of your home. In 1983, you bought the property for $100,000, of which $90,000 was allocated to the house. The house now has a fair market value of $185,000. You compute depreciation on the cost basis of $90,000, which is lower than the value. You multiply $90,000 by 10% (business-use percentage), which gives you $9,000 as the depreciable basis of the business part of the house. As you started business use in the fourth month of 1996, you multiply the depreciable basis of $9,000 by 1.819%. This percentage is listed for the fourth month in the depreciation rate table for 39-year property shown below. Your depreciation deduction is $163.71 (9,000 × 1.819%).

Nonresidential Real Property (31.5 Years —For property placed in service after 1986 and before May 13, 1993)

Use the column for the month of taxable year placed in service

Year	1	2	3	4	5	6	7	8	9	10	11	12
1	3.042%	2.778%	2.513%	2.249%	1.984%	1.720%	1.455%	1.190%	0.926%	0.661%	0.397%	0.132%
2–7	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175
8	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.175	3.175	3.175	3.175	3.175
9	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
10	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174

Nonresidential Real Property (39 Years —For property placed in service after May 12, 1993)

Use the column for the month of taxable year placed in service

Year	1	2	3	4	5	6	7	8	9	10	11	12
1	2.461%	2.247%	2.033%	1.819%	1.605%	1.391%	1.177%	0.963%	0.749%	0.535%	0.321%	0.107%
2–39	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564
40	0.107	0.321	0.535	0.749	0.963	1.177	1.391	1.605	1.819	2.033	2.247	2.461

¶40.13 Allocating Expenses to Business Use

You may allocate to home office use qualifying expenses (¶40.12) as follows: If the rooms are not equal or approximately equal in size, compare the number of square feet of space used for business with the total number of square feet in the home and then apply the resulting percentage to the total deductible expenses.

If all rooms in your home are approximately the same size, you may base the allocation on a comparison of the number of rooms used as an office to the total number of rooms.

EXAMPLE

A doctor rents a apartment using three rooms for his office and seven rooms for his residence. The rooms are not equal in size. The apartment has 2,000 square feet; the office has 600. He allocated 30% (600/2,000) of the following expenses to his office:

	Total	*Office*	*Residence*
Rent	$ 7,200	$2,160	$5,040
Light	600	180	420
Heat	1,000	300	700
Wages of domestic	2,000	600	1,400
	$10,800	$3,240	$7,560

Thus, $3,240 is deductible as office expenses, subject to the income limitation of ¶40.14.

¶40.14 Business Income May Limit Home Office Deductions

Deductions for the business portion (¶40.13) of utilities, maintenance, and insurance costs, as well as depreciation deductions, may not exceed net income derived from the office use. To make sure that deductible expenses do not exceed income, the IRS requires you to use Form 8829. If you do not realize income during the year, no deduction is allowed. For example, you are a full-time writer and use an office in your home. You do not sell any of your work this year or receive any advances or royalties. You may not claim a home office deduction for this year. *See also* ¶40.8 on rules for writers and artists.

Part II of Form 8829 limits the deduction of home office expenses to net income derived from office use. You start with the tentative profit from Schedule C. If you sold your home during the year, increase the tentative profit by any net gain (or decrease tentative profit by any net loss) that is allocable to the office area and reported on Schedule D or Form 4797. The following expenses are listed in Part II of Form 8829 for purposes of applying the income limit: Casualty losses affecting the residence, deductible mortgage interest, real estate taxes, home insurance premiums, repair and maintenance expenses for the residence, utility expenses, and depreciation. Business expenses not related to the home are deducted on the appropriate lines of Schedule C. For example, a salary paid to a secretary is deducted on Line 26 of Schedule C; the cost of depreciable equipment is deducted on Line 13 of Schedule C.

Expenses disallowed because of the income limitation may be carried forward and treated as home office expenses in a later tax year (Part IV, Form 8829). The carryover as well as the expenses of the later year are subject to the income limitation of that year. For example, tentative net profit on Line 29, Schedule C, is $1,000. Rent and other expenses allocated to home office business are $2,000. Only $1,000 of the expenses are deductible; $1,000 is carried over to 1997.

The amount of real estate taxes, mortgage interest, or casualty losses not allocated to home office use may be claimed as itemized deductions on Schedule A.

EXAMPLE

Smith does sideline business consulting from a home office which he uses exclusively for business for all of 1996. His income in 1996 from consulting services is $12,400. He paid $3,600 for a photocopy machine and $4,000 for a computer, and had office telephone expenses of $600 and office supply costs of $800.

In addition, his home costs are:

Mortgage interest	$10,000
Real estate taxes	4,000
Insurance	1,200
Utilities	1,800

His office space took up 20% of the area of his home, and he figured depreciation allocated to business use was $1,200.

On Schedule C he claims first-year expensing for the copier and the computer, and deducts the cost of the business phone and supplies on Schedule C. This gives a tentative profit of $3,400 ($12,400 – $9,000) on Line 29, Schedule C.

In Part I of Form 8829, he lists the total area of the home and the area used for business, showing 20% business use.

In Part II, he enters the home costs listed above. We have taken only the relevant lines of the Form 8829 as an illustration. A sample Form 8829 is on page 533.

Line—		*Column B Entries—*	
8.	Tentative profit from Schedule C, Line 29		$3,400
10.	Mortgage interest	$10,000	
11.	Real estate taxes	4,000	
12.	Total	$14,000	
13. & 14.	Business portion of Line 12		2,800
15.	Remaining tentative profit		600
17.	Insurance	1,200	
19.	Utilities	1,800	
21.	Total	3,000	
22 & 25.	Business portion of Line 21		600
26.	Remaining tentative profit		0

No depreciation is deductible because there is no remaining business income and excess home office expenses may not generate a loss deduction. The depreciation is carried over to 1997. Home office expenses of $3,400 from Lines 14 and 25 are deducted on Line 30, Schedule C.

¶40.15 Home Office for Sideline Business

You may have an occupation and also run a sideline business from an office in your home. The home office expenses are deductible on Form 8829 if the office is a principal place of operating the sideline business or a place to meet with clients, customers, or patients. *See* the deduction tests at ¶40.11 and the income limit computation at ¶40.14. Managing rental property may qualify as a business.

EXAMPLE

A doctor is employed full time by a hospital. He also owns six rental properties which he personally manages. He uses one bedroom in his two-bedroom home exclusively as an office to manage the properties. The room is furnished with a desk, bookcase, filing cabinet, calculators, and answering service; furnishings and other materials for preparing rental units for tenants are stored there. He may deduct expenses allocable to the home office.

Substantiating the sideline business. In claiming home office expenses of a sideline business, it is important to be ready to prove that you are actually in business; *see* ¶40.9. The Tax Court has held that activities in seeking new tenants, supplying furnishings, and cleaning and preparing six units for tenants are sufficiently systematic and continuous to put a person in the rental real estate business. In some cases, the rental of even a single piece of real property may be a business if additional services are provided such as cleaning or maid service.

Managing your own securities portfolio. Investors managing their own securities portfolios may find it difficult to convince a court that investment management is a business activity. According to Congressional committee reports, a home office deduction should be denied to an investor who uses a home office to read financial periodicals and reports, clip bond coupons, and perform similar activities. In one case, the Claims Court allowed a deduction to Moller, who spent about 40 hours a week at a home office managing a substantial stock portfolio. The Claims Court held these activities amounted to a business. However, an appeals court reversed the decision. According to the appeals court, the test is whether or not a person is a trader. A trader is in a business; an investor is not. A trader buys and sells frequently to catch daily market swings. An investor buys securities for capital appreciation and income without regard to daily market developments. Therefore, to be a trader, one's activities must be directed to short-term trading, not the long-term holding of investments. Here, Moller was an investor; he was primarily interested in the long-term growth potential of stock. He did not earn his income from the short-term turnovers of stocks. He had no significant trading profits. His interest and dividend income was 98% of his income.

¶40.16 Depreciation of Office in Cooperative Apartment

If your home office meets the tests of ¶40.11, you may deduct depreciation on your stock interest in the cooperative. The basis for depreciation may be your share of the cooperative corporation's basis for the building or an amount computed from the price you paid for the stock. The method you use depends on whether you are the first or a later owner of the stock.

You are the first owner. In figuring your depreciation, you start with the cooperative's depreciable basis of the building. You then take your share of depreciation according to the percentage of stock interest you own. The cooperative can provide the details needed for the computation.

If space in the building is rented to commercial tenants who do not have stock interests in the corporation, the total allowable depreciation is reduced by the amount allocated to the space used by the commercial tenants.

You are a later owner of the cooperative's stock. When you buy stock from a prior owner, your depreciable basis is determined by the price of your stock and your share of the coop's outstanding mortgage, reduced by amounts allocable to land and to commercial space. *See* ¶29.19 for further details.

Figuring Net Operating Losses for Refund of Prior Taxes

¶40.17 Net Operating Losses for Refund of Prior Taxes

A loss incurred in your profession or unincorporated business is deducted from other income reported on Form 1040. If a 1996 loss (plus any casualty loss) exceeds income, the excess may be first carried back to 1993, 1994, or 1995, and *then* forward 15 years to 1997 through 2011 until it is used up. A loss carried back to a prior year reduces income of that year and entitles you to a refund. A loss applied to a later year reduces income for that year.

You may elect to carry forward your loss for 15 years, foregoing the three-year carryback; *see* ¶40.21.

The rules below apply not only to self-employed individuals, farmers, and professionals, but also to individuals whose casualty losses exceed income, stockholders in S corporations, and partners whose partnerships have suffered losses. Each partner claims his or her share of the partnership loss.

Carryover of loss from prior year to 1996. If you had a net operating loss in an earlier year which is being carried forward to 1996, the loss carryover is reported as a minus figure on Line 21 of Form 1040. You must attach a detailed statement showing how you figured the carryover. The Example below shows you how a 1996 loss could be carried back and forward.

EXAMPLE

You have a 1996 business net operating loss of $650.

Year	*Income*	*Loss*	*Loss carried back or forward to income*
1993	$50		($50)
1994	80		(80)
1995	60		(60)
1996		($650)	
1997	20		(20)
1998	40		(40)
1999	50		(50)
2000	100		(100)
2001	100		(100)
2002	125		(125)
2003	150		(25)

Change in marital status. If you incur a net operating loss while single but are married filing jointly in a carryback or carryforward year, the loss may be used only to offset your own income on the joint return.

If the net operating loss was claimed on a joint return and in the carryback or carryforward year you are not filing jointly with that same spouse, only your allocable share of the original loss may be claimed; *see* IRS Publication 536.

Passive activity limitation. Losses subject to passive activity rules of Chapter 10 are not deductible as net operating losses. However, losses of rental operations coming within the $25,000 allowance of ¶10.2 may be treated as a net operating loss if the loss exceeds passive and other income.

Restrictions on loss after accounting method change. You may realize a net operating loss for a short taxable year created by the accounting change. As a condition of allowing the accounting method change, the IRS may require you to forego the right to a loss carryback and agree to a six-year carryforward period.

EXAMPLE

You want to change from a calendar year to a fiscal year ending April 30. Assume further that May through October is your peak selling period. Thus, you may have a net operating loss for the short taxable year January 1–April 30 because of slack business. According to the IRS, if the net operating loss is $10,000 or less, you may apply the regular net operating loss rules that allow you to carry back the loss three years and then forward 15 years. But if the net operating loss exceeds $10,000 and the short period is less than nine months, the operating loss must be deducted ratably over a six-year period starting with the first tax year after the short period.

¶40.18 Your Net Operating Loss

A net operating loss is generally the excess of deductible business expenses over business income. The net operating loss may also include the following losses and deductions:

- Casualty and theft losses, even if the property was used for personal purposes; *see* Chapter 18.
- Expenses of moving to a new job location; *see* Chapter 21.
- Deductible job expenses such as travel expenses, work clothes, costs, and union dues; *see* ¶19.3.
- Your share of a partnership or S corporation operating loss.
- Loss on the sale of Small Business Investment Company stock; *see* ¶5.7.
- Loss incurred on Section 1244 stock; *see* ¶5.8.

An operating loss may *not* include:

- Net operating loss carryback or carryover from any year.
- Capital losses that exceed capital gain.
- Excess of nonbusiness deductions over nonbusiness income plus nonbusiness net capital gain.
- Deductions for personal exemptions.
- A self-employed person's contribution to a Keogh plan.
- An IRA deduction.

Income from other sources may eliminate or reduce your net operating loss.

EXAMPLE

You are self-employed and incur a business loss of $10,000. Your spouse earns a salary of $10,000. When you file a joint return, your business loss will be eliminated by your spouse's salary. Similarly, if you also had salary from another position, the salary would reduce your business loss.

¶40.19 Form 1045

You compute your net operating loss deduction on Form 1045. You start with adjusted gross income and personal deductions shown on your tax return. As these figures include items not allowed for net operating loss purposes, you follow the line-by-line steps of Form 1045 to eliminate them. That is, you reduce the loss by the nonallowed items such as deductions for personal exemptions, net capital loss, and nonbusiness deductions exceeding nonbusiness income. On the schedule, the reductions are described as adjustments. The Example at the end of this section illustrates the steps in the schedule.

Adjustment for nonbusiness deductions. Nonbusiness expenses that exceed nonbusiness income may not be included in a net operating loss deduction. Nonbusiness deductions include deductions for IRA and Keogh plans and itemized deductions such as charitable contributions, interest expense, state taxes, and medical expenses. Do not include in this non-allowed group deductible casualty and theft losses, which for net operating loss purposes are treated as business losses. If you do not claim itemized deductions in the year of the loss, you must treat the standard deduction as a nonbusiness deduction.

Nonbusiness income is income that is *not* from a trade or business—such as dividends, interest, and annuity income. The excess of nonbusiness capital gains over nonbusiness capital losses is also treated as part of nonbusiness income.

EXAMPLE

Income from dividends and interest is $6,000 and nonbusiness deductions are $6,500. The excess deduction of $500 is an adjustment that reduces your loss on Form 1045.

Adjustment for capital losses. A net nonbusiness capital loss may not be included in a net operating loss. If nonbusiness capital losses exceed nonbusiness capital gains, the excess is an adjustment that reduces your loss on Form 1045. In figuring your loss, you may take into account business capital losses only up to the total of business capital gains plus any nonbusiness capital gains remaining after the nonbusiness deduction adjustment discussed earlier.

At-risk loss limitations. The loss used to figure your net operating loss deduction is subject to the at-risk rules discussed at ¶10.17. If part of your investment is in nonrecourse loans or is otherwise not at risk, you must compute your deductible loss on Form 6198, which you attach to Form 1040. The deductible loss from Form 6198 is reflected in the income and deduction figures you enter on the Form 1045 schedule to compute your net operating loss deduction.

EXAMPLE

You are single and in 1996 you have a salary of $3,000, interest of $1,200, a net business loss of $10,000 (income of $50,000 and expenses of $60,000), itemized Schedule A deductions of $6,000, and a net nonbusiness capital gain of $1,000. Your net operating loss is $7,000. The following computation approximates the steps of the Form 1045 computation schedule starting from the line showing your negative adjusted gross income of $4,800.

Salary		$ 3,000
Interest		1,200
Capital gain income		1,000
Business loss		($10,000)
Adjusted gross income		($ 4,800)
Add: Exemption and itemized deductions		(8,550)
		($13,350)
Adjustments:		
Exemption	$2,550	
Excess nonbusiness deduction*	3,800	6,350
Net operating loss		($7,000)

**The excess nonbusiness expenses deduction was figured as follows:*

Itemized deductions		$6,000
Net capital gain income	$1,000	
Interest income	1,200	2,200
Excess		$3,800

¶40.20 How To Carry Back Your Net Operating Loss

Tax year 1993 is the first year to which you may carry back your 1996 net operating loss. When you carry back the loss to 1993, you recompute your 1993 tax on Form 1045 by deducting the 1996 net operating loss. The net operating loss is deducted from the amount of your original 1993 adjusted gross income. Because of the reduction to adjusted gross income, you have to increase any 1993 medical expense and casualty loss deduction when recomputing 1993 income. You do not have to change the amount of your 1993 charitable deduction. *See* the instructions to Form 1045 and also IRS Publication 536 for details of the recomputation calculation.

After recomputing the 1993 tax on Form 1045, your refund is the difference between the tax originally paid for 1993 and the lower tax figured after deducting the net operating loss deduction.

Use Form 1045 as a "quick refund" claim. The IRS will usually allow or reject your claim within 90 days from the time you file Form 1045. Do not attach Form 1045 to your 1996 Form 1040. File

Form 1045 separately, together with a copy of your return. You may file Form 1045 within 12 months after the end of your tax year. Thus, if you are a calendar-year taxpayer, you have until December 31, 1997, to carry back a 1996 loss to 1993 on Form 1045. If the IRS allows the refund, it may still determine later that the refund was excessive and assess additional tax.

Although using Form 1045 is the quickest way to obtain the refund, you may instead file an amended return on Form 1040X to claim the refund. You have three years after the due date (including extensions) of your 1996 tax return to file Form 1040X. Thus, to claim a refund on Form 1040X for 1993, because of a net operating loss carried back three years from 1996, you have until April 15, 2000, to file. On Form 1040X, you must attach a statement detailing how the loss carryback was figured; the schedule from Form 1045 for computing the loss may be used.

Operating losses from more than one year. If you have more than one year net operating loss to be carried to the same taxable year, you apply the loss from the earliest year first.

EXAMPLE

You had net operating losses in both 1995 and 1996 of $6,000 and $10,000, respectively. Your taxable income in 1992 was $5,000. You carried the $6,000 loss from 1995 to 1992, leaving an unused portion of $1,000 to be carried to 1993. Therefore, you have two losses to be applied against 1993 income—the unused portion of the 1995 loss and the 1996 loss. First apply the unused portion of the 1995 loss, and then apply the 1996 loss. On Form 1045 or 1040X, attach a detailed schedule showing the net operating loss computation for each year.

Any part of the loss that may not be deducted in 1993 is carried to 1994. *See* the instructions to Form 1045 and also IRS Publication 536 for details of this computation.

¶40.21 Election To Carry Forward Losses

Instead of carrying back your net operating loss under the rules of ¶40.20, you may elect to forego the carryback. Instead, you just carry forward losses. The carryforward period is still 15 years under the election. The election is irrevocable.

If you are carrying forward a net operating loss from an earlier year to 1996, report the loss carryover as a minus figure on Line 21 of Form 1040 and attach a statement explaining how the carryover was computed.

Advantage of Relinquishing the Carryback

You will generally make the election to relinquish the carryback if you expect greater tax savings by carrying the loss forward. You might also make the election if you are concerned you might be audited for earlier years if you carry back a loss for a refund. You make the election by attaching a statement to this effect to your return for the year of the loss, which must be filed by the due date plus extensions. The IRS refuses to allow a late election and received court approval for its position.

Business Tax Credits

¶40.22 General Business Credit

The general business credit includes the following credits:

- The work opportunity credit on Form 5884; *see* below.
- The investment credit on Form 3468, consisting of the rehabilitation property credit, the energy credit, and the reforestation credit;
- The alcohol fuels credit on Form 6478;
- The research credit on Form 6765; *see* below;
- The low-income housing credit on Form 8586;
- The enhanced oil recovery credit on Form 8830;
- The disabled access credit on Form 8826;
- The renewable electricity production credit on Form 8835;
- The credit for wages paid in an empowerment zone on Form 8844;
- The Indian employment credit on Form 8845;
- The credit for employer-paid Social Security and Medicare taxes on certain tips received by employees of food and beverage establishments on Form 8846; and
- The credit for contributions to certain community development corporations on Form 8847.

The low-income housing credit and the rehabilitation tax credit are discussed at ¶31.9.

Work opportunity credit. A new law replaces the expired targeted job credit with a similar "work opportunity credit," which employers may claim only for qualified workers beginning work after September 30, 1996, and before October 1, 1997. The credit is 35% of the first $6,000 of wages paid, or $2,100. For qualified summer youth employees, the maximum credit is $1,050 (35% of the first $3,000 of wages). Targeted groups include AFDC recipients, high-risk youths, vocational rehabilitation referrals, and qualifying veterans, ex-felons, summer youth employees, and food stamp recipients. For further details, *see* the instructions to Form 5884.

Research credit. The research credit, which expired June 30, 1995, was extended and modified by a new law, but only for the period July 1, 1996 through May 31, 1997. For eligible expenses and computation rules, *see* the instructions to Form 6765.

Computing the general business credit. You compute each credit separately. If you claim only one credit, that credit is considered your *general business credit* for 1996. The credit is subject to a limitation based on tax liability which is figured on the form used to compute that particular credit. You then enter the allowable credit as your general business credit on Form 1040.

If you claim more than one credit, the credits are combined into one general business credit on Form 3800, except for the empowerment zone wages credit, which is figured on Form 8844 and not carried to Form 3800. Each of the other credits is first computed separately and then listed on Form 3800. The combined credit is subject to a limitation based on tax liability. To figure the limit, you must compute tentative alternative minimum tax (AMT) on Form 6251 even if the complete computation on Form 6251 shows that you do not have an actual AMT liability for the year. Your limit for the general business credit on Form 3800 is your regular tax liability (after tax credits other than the general business credit), *plus* actual AMT liability from Form 6251 (if any), *minus* whichever of the following is larger: either (1) tentative AMT from Form 6251; or (2) 25% of your regular income tax liability (after other credits) over $25,000.

Keep separate records of each of the component credits making up the general business credit. The credits are considered to be used up in a specific order; *see* the instructions to Form 3800.

If your full 1996 general business credit may not be claimed because of the tax liability limitation, you may be able to *carry back* the excess three years, starting with the earliest year. Check the Form 3800 instructions for restrictions on carrying back certain credits. After the carryback, any remaining credit may be *carried forward* 15 years until used up. The carrybacks and carryforwards are listed on Form 3800.

If you have business credits from a passive activity under the rules of Chapter 10, you must figure the credits on Form 8582-CR; generally, the credits are limited to the tax liability from passive activities.

¶40.23 Other Fuel-Related Credits

If on or before August 20, 1996, you bought a *diesel-powered car or truck* weighing 10,000 pounds or less, you may claim a one-time credit for the diesel fuel tax. You must be the original purchaser—that is, the first purchaser for use other than resale. The credit for an auto is $102, and for a truck or van, $198. The credit is claimed on Form 4136. For depreciation purposes, basis is reduced by the credit. Thus, if a new diesel-powered business car is purchased for $18,000, basis is reduced by the $102 credit to $17,898. If you bought the diesel-powered vehicle after August 20, 1996, you may not claim the credit.

For a qualified business use, a refundable credit may be claimed for *gasoline or special fuels*. For example, a credit applies for fuel used in non-highway vehicles (other than motorboats), including generators, compressors, fork-lift trucks, and bulldozers. A credit may also be claimed for aviation fuel used for farming or commercial aviation. Different credit rates apply depending on the type of fuel. You must claim the credit on a timely filed income tax return, including extensions. You compute the credit on Form 4136, which you attach to Form 1040. For further details, *see* IRS Publication 378; farmers should *see* IRS Publication 225.

Electric vehicles. A credit for 10% of the cost of a qualified electric motor vehicle may be claimed on Form 8834. The maximum credit is $4,000 per vehicle. On Form 3800 you include the qualified electric motor vehicle credit in the total of other credits that reduce regular tax before the general business credit limit (¶40.22) is figured.